Clark Capital Management Group

Portfolio Perspectives

Did the Trump Rally Move Value Stocks and Small Caps Too Far Too Fast?

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Recent market movements offer possible evidence of a major, long-term trend change favoring value stocks.

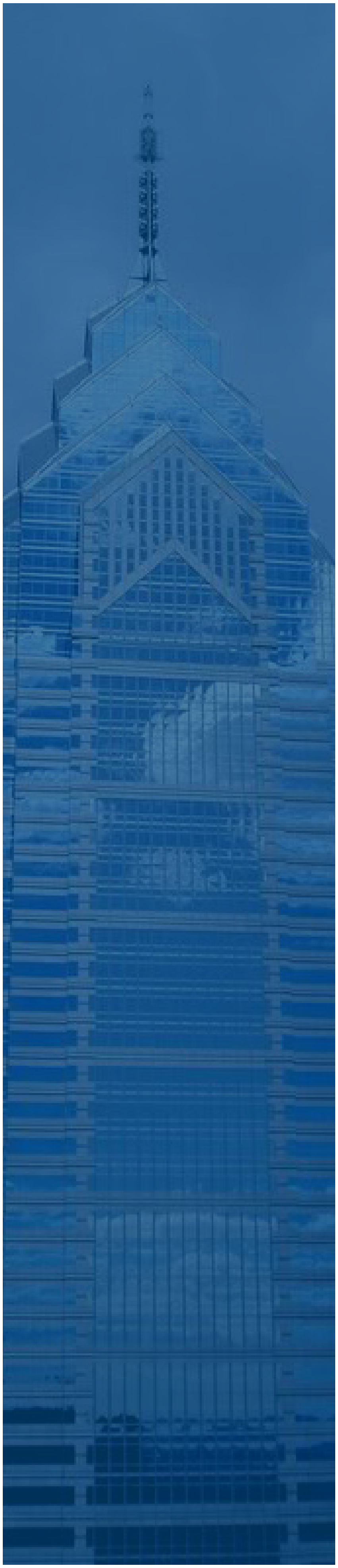
Prior to 2016, for a number of years growth stocks outperformed value stocks. That wasn't particularly surprising as we were in a period of weak to moderate economic growth. Value stocks, however, often require increased economic growth to prosper — a scenario the market is betting on. This bet is seen in the outperformance in small caps, financials, and industrials since Election Day and throughout 2016. For the moment, the market's movement can be described as speculative because a continued trend of higher economic growth has yet to develop beyond one or two months. This expectation puts renewed pressure on these stocks to deliver accelerated earnings and growth.

Multiple Expansion Puts the Pressure On

From a fundamental perspective, we have concerns about small cap valuations in the long term, as their multiples have increased considerably in 2016. Our research shows that valuations are at the high end of the normal range, though not in bubble territory. According to Ned Davis Research, as of November 30th, the P/E of its Small Cap Universe was 29.4, 30% above the long-term median of 22.6. The rally through mid-December has made these valuations even more extreme. The burst of performance in small caps was likely rooted in President-elect Trump's stated goals of a lower corporate tax, less regulation, a stronger dollar, and greater domestic production. While historically small cap multiples can remain at these levels for some time, multiples have rarely expanded from here. This means that for markets to go higher from here, companies must deliver earnings. Otherwise, the market is vulnerable to decline.

Multiple expansions have been particularly large among value stocks (defined by Morningstar Style Box). Twelve month forward P/E ratios for value indexes have risen by 16 to 30% this year with Mid Cap Value's 30% multiple increase leading the way. However, the trend towards value has been longer-lasting than just in the post-election period and really began when markets bottomed in February. The strong performance by value stocks stands in strong contrast to the performance of growth stocks, the multiple of which has been flat to declining for much of the year.

To demonstrate the magnitude of the move in value stocks: their forward multiples are nearly the same as that of growth stocks. For example, as of November 30th, the S&P MidCap Value Index has a forward P/E of 21.33 while the S&P MidCap Growth Index has a P/E of 21.37. The S&P Small Cap Value Index has a forward P/E of 22.63 while the



S&P Small Cap Growth Index's P/E is 23.28. Value stocks are very stretched by these measures. After all, by definition growth stocks have faster earnings growth than value stocks and, all else being equal, an investor would choose a faster growing company over a slower growing company every time given virtually identical valuations. For this reason, value stocks now carry greater risk because investors are expecting higher earnings, and historically these stocks have not consistently delivered, at least during the recent era of modest economic growth.

Capitalizing on Momentum

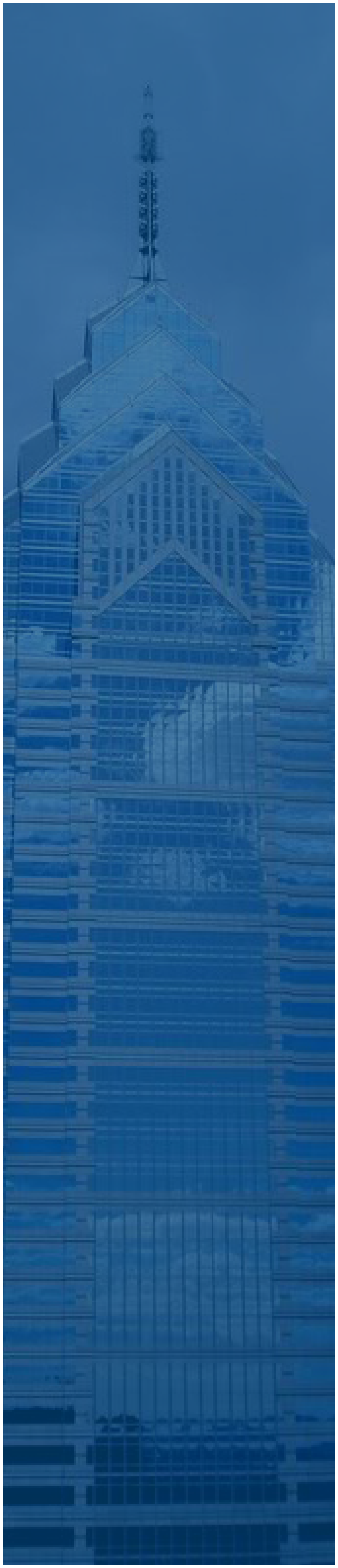
Based on this valuation analysis, you might think that Clark Capital is quite bearish on small cap and value stocks and avoiding them. In reality, our allocation to the space depends on each portfolio's individual methodology. Our relative strength-based portfolios feature these stocks heavily, as they have been market leaders even before the post-election spike. This methodology bets on and believes that value stocks will be up to the task facing them. Research in the academic finance field shows that stocks which have shown intermediate-term momentum often have that momentum continue into the future. This persistence of performance is the well known "momentum factor" at play.

This top-down, momentum-driven strategy is in contrast to our individual bottom-up stock selection portfolios where valuation is a key metric. In such portfolios, growth stocks and larger cap stocks are currently ranked as more attractive than small cap and value stocks. We believe these diverging theories reinforce the importance of diversifying not only by asset class but also by investment methodology.

Factoring in Federal Reserve Action

In the meantime, the rate hike from the Federal Reserve adds complexity. Some fear financial stocks or even the broader market might pull back amid mandated rate increases. However, data from the Ned Davis Research Group mollifies these concerns. Their historical research indicates that slower increases have little or no negative impact on the market. A greater time horizon allows investors and companies to acclimate to the environment. Moreover, rates are at such a low point that these first increases should not come as a shock to the system. For the moment, the Federal Reserve has been clear on setting a gradual pace concerning rate increases.

Value stocks may be poised to continue their outperformance. However, their loftier valuations leaves them with the burden of high expectations and the need to deliver. The apparent trend favoring value stocks will only hold if we see increased growth in the U.S. and world economies. Such growth may depend on the market's conviction in and the execution of Trump's infrastructure spending and tax plans. If these plans materialize in conjunction with reduced taxes and increased spending, then we may see faster growth. The effectiveness of these measures depends, in part, on how swiftly they can



be implemented before increased rates make the job more difficult.

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Mason Wev joined Clark Capital Management Group, Inc. in 2005 as a Portfolio Manager. He is a member of the Clark Capital Investment Committee, contributing to asset allocation policy and security selection. Mason has more than a decade of experience in the investment industry. He is responsible for quantitative investment analysis, security selection, and communicating the firm's investment policy to wealth advisors and consultants. He participates in the research and product development efforts of the Portfolio Team. A graduate of Dickinson College, Mason earned an M.B.A. in International Management from the Garvin School of Management at Thunderbird (the American Graduate School of International Management). He is a CFA® charter holder and a Chartered Market Technician.

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